Property Casualty Insurers
Association of America
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September 16, 2016

Robert deV. Frierson
Secretary
Board of Governors of the Federal Reserve System
20th Street and Constitution Avenue, N.W.
Washington, DC 20551

Re: Advance Notice of Proposed Rulemaking (Docket No, R-1539; RIN 7100 AE 53) on Capital Requirements for Supervised Institutions Significantly Engaged in Insurance Activities

Dear Mr. Frierson:

The Property Casualty Insurers Association of America (PCI) appreciates the opportunity to comment on the Federal Reserve Board's ("Board") advance notice of proposed rulemaking ("ANPR") on capital requirements for supervised institutions significantly engaged in insurance activities. PCI's roughly 1,000 member property/casualty insurance companies write 35% of the U.S. industry's premium volume and range from the largest global insurers to the smallest single-state writers. Seven PCI member groups are subject to the Board's group-wide supervision authority as savings and loan holding companies, and are directly affected by the ANPR. The rest of PCI's membership also has a strong interest in the Board's work on an insurance group capital standard, particularly as it may influence development of the International Association of Insurance Supervisors' (IAIS) Insurance Capital Standard and the National Association of Insurance Commissioners (NAIC) Group Capital Calculation,

PCI's mission is to promote and protect the vitality of a competitive private insurance market for the benefit of consumers and insurers. It is in that spirit that we offer the following comments on the Board's ANPR, and look forward to continuing to work with the Board as it develops its group capital standard.

General remarks

Strong support for insurance-specific capital standard

PCI applauds the Board for its appropriate recognition that an insurance group capital standard should be "appropriately tailored to the business of insurance." The ANPR correctly acknowledges the significant differences between the insurance and banking business models, and the resulting need for an insurance group capital standard to be structured differently than the banking capital standard.

Strong support for Building Block Approach

PCI strongly supports the Building Block Approach (BBA) described in the ANPR as the only group capital standard for supervised institutions significantly engaged in insurance activities, including systemically important financial institutions (SIFIs). We will further discuss our reasons in the answer to Question 6, but we agree with the "key strengths" cited after Question 11 in the ANPR. The BBA follows the state-based risk-based capital system for insurance legal entities in the U.S. that has been tested and found robust over more than twenty years and recognizes the important role played by the industry's primary functional regulators. Because it makes maximum use of the insurance industry's existing capital requirements, it will be less costly for regulators, companies and the consumers those companies serve than creation of an entirely new consolidated capital requirement. As the ANPR notes, the BBA "would produce regulatory capital requirements that are tailored to the risks of each distinct jurisdiction and line of business of the institution." We also note that the BBA is consistent with, and follows the intent of, the Insurance Capital Standards Clarification Act of 2014.

We caution, however, that the BBA approach will be undermined if the Board makes numerous changes to items such as regulatory action thresholds, the definition of qualifying capital, capital tiers and similar areas. The greater the Board's deviations, the more the standard becomes a conflicting system with more burdens and fewer benefits.

Oppose bifurcated approach – BBA should apply to all Board-supervised insurance groups
The BBA is vastly preferable to the Consolidated Approach (CA), even for SIFIs. Among other things, the BBA approach better reveals how the individual members of the group are faring during stressed situations.

Significant problems with the CA include:

- Capital Uncertainty: The ANPR indicates that the CA's required capital framework will at first be coarse and risk insensitive, meaning that it may take years of adjustments to be a robust capital framework. This is inconsistent with the Fed's goal of establishing meaningful capital rules in the short to medium-term and will subject insurers to years of capital uncertainty.

- Solvency accounting conflicts: The CA will complicate risk management decisions by introducing significantly different accounting, valuation and risk factors than the capital framework that governs the operating companies (and which comprise the BBA approach). While such conflicts exist today between earnings and solvency accounting measures, conflicts among solvency measures are unprecedented in the U.S. marketplace and threaten conflicting choices in managing risk against two non-similar solvency measures.

- Level playing field and competitive distortions: Firms subject to the CA will be at competitive disadvantages relative to non-SIFI peers in whichever markets the coarse, insensitive CA results in greater capital requirements or where CA and local accounting measures suggest contradictory risk management practices. This may result in unexpected market distortions with limited benefit.

- BBA better attuned to the business of insurance: The insurance portion of the BBA is based upon the state risk-based capital (RBC) system, which has been tested over more than 20 years and continually adjusted to better fit the specifics of the U.S. insurance industry. The CA would begin as a far more crude and less risk sensitive system, and would likely take many years to fit the insurance business as well as the BBA does.

Source of strength concept should not apply to insurance legal entities
We are concerned by the statement in the discussion before question 38 that "the parent holding company should be a source of capital strength to the entire entity, including to the subsidiary insurance companies . . ." It is inappropriate to apply the source of strength doctrine to insurance companies in the group. The Board should not be making judgments about the capital soundness of insurers. This determination should remain within the jurisdiction of the state insurance commissioners, who possess the expertise to address such matters. Neither should the Board apply the source of strength doctrine where insurance legal entities which require resolution are resolved under the state-based insurance liquidation and guaranty fund system. It is inconsistent for the Board to say that it is respecting state-based insurance regulation without giving the same respect to the state insolvency and guaranty fund system.

Where a holding company is primarily engaged in banking activities, the Board has a legitimate role to play in addressing contagion risk. Insurance holding companies do not present the same contagion risks as banks and there is no reason to assume that every non-depository institution should be rescued by the parent company. Such decisions should be made by the insurer's primary state regulator. It would be an unauthorized expansion of statutory authority for the Board to try to extend its regulatory authority indirectly to insurance or commercial activities of insurance holding companies. The Board's attention should be focused on ensuring the safety and soundness of depository institutions rather than addressing peripheral matters that do not threaten the solvency of the depository institution to any meaningful degree. It is also critical that individual legal entities within an insurance group be allowed to become insolvent where their failure does not jeopardize the safety and soundness of either the holding company or the depository institution. Insolvencies of insurers are well handled by the state rehabilitation, liquidation and guaranty fund system. Insurance groups may include legal entities whose only purpose is to run off a block of business. In other cases, a group may establish an insurer in a particular jurisdiction that is not intended to have the capital support of the

group. If there is no significant risk to the holding company or the depository institution, the Board should not interfere with these arrangements.

Need for field testing program before implementation

Before any final capital standard is adopted, the Board should engage in an appropriate voluntary field testing program (similar to quantitative impact studies) to establish the effects of its proposed approach. Any first iteration of something as complex as a group capital standard will have some flaws, and it is important that significant flaws be corrected before the standard is put into effect.

Need for additional comment cycles

We appreciate and commend the Board for exposing its thinking for comment before it has made many of the critical decisions that are necessary. We urge the Board to continue to follow a transparent process in developing and implementing its capital framework. Insurance groups subject to the framework will be in competition with insurers that are not, and it will be important to all players to fully understand the rules the Board is developing. The Board should request public comment on as many future proposed versions of this proposal as are needed to make it realistic and workable. Once the standard is adopted, similar to the process the NAIC uses in maintaining its risk-based capital formula, the Board should also allow stakeholders to submit annual proposals for enhancement and consider them in a transparent manner.

Responses to questions posed in the ANPR:

1. Are these identified considerations appropriate? Are there other considerations the Board should incorporate in its evaluation of capital frameworks for supervised institutions significantly engaged in insurance activities?

PCI agrees with the considerations identified by the Board, in particular that "the capital framework also should be based on U.S. regulatory and accounting standards and not foreign regulatory and accounting standards in order to best meet the needs of the U.S. financial system and insurance markets while reflecting the risks inherent in the business of insurance." Therefore, to the extent the framework relates to insurance legal entities, it must be tailored to insurance activities, not banking activities. The ANPR should be clarified to provide that the reference above includes the regulatory and accounting standards established and applied by state insurance regulators. These standards are critical to the successful state-based system, and the Board should apply the same respect to this portion of the state regulatory system as it does to the rest of the system.

Proportionality should also be a key consideration. Insurance groups that control smaller depository institutions should be subject to more flexible regulatory and supervisory Board oversight, whose principal focus should be the risk the affiliation presents to the depository institution. Regulation of non-SIFI insurance holding companies should not extend beyond that necessary to address systemic risk. Credit should be given for risk-mitigating activities, including third-party party protection provided for the solvency of the group's depository institutions.

In the ANPR, the Board seeks to design a regulatory capital framework for supervised institutions significantly engaged in insurance activities to substantially mitigate any threats to financial stability that the institution might pose. The Board's definition of "financial stability" here is not clear, and should be defined as presenting potential danger to the U.S. financial system or general economy. Many studies have shown that "traditional" insurance, in particular property/casualty insurance, poses no systemic risk or threat to financial stability. As we have commented above, the Board's concern should be focused upon holding company and depository institution safety and soundness. Financial stability should be a primary area of concern only in connection with institutions that have been designated as SIFIs.

The Board also seeks to design a capital framework to enable Board-supervised insurance holding companies to absorb losses and continue operations as a going concern throughout times of economic, financial and insurance-related stress. The Board should explicitly acknowledge that this concept does not affect the power of a state insurance authority to place a U.S. insurance legal entity within a holding company into rehabilitation under a state-based system without affecting the ability of the financial group to continue as a going concern. The ANPR also expresses a desire to strike a balance that increases comparability and

transparency across firms. We request clarification with regard to "transparency" to better understand what components of the calculation and results will be made available to the stakeholders, including the public, competitors, and other functional regulators.

2. Should the same capital framework apply to all supervised insurance institutions?

For the reasons mentioned in our general comments, the Building Block Approach should be applied to all insurance groups supervised by the Board. The goal to substantially mitigate any threats to financial stability should only be applied to SIFIs. If the Consolidated Approach (CA) is also developed, it should be limited to SIFIs.

3. What criteria should the Board use to determine whether a supervised insurance institution should be subject to regulatory capital rules tailored to the business of insurance?

We assume this question refers to how much insurance activity should be carried on by a depository institution holding company in order for the insurance capital standard to be applied to it. One of the approaches the Board should consider is whether the size of a group's insurance activities, measured by percentage of total assets, exceed the size of any other category (banking, securities, or non-banking financial) of the holding company's financial activities. In any case, a weighted average (three years) should be used to evaluate whether a group is considered to be predominantly an insurance group, and a group dropping below the threshold should be allowed a three-year grace period before converting to another group capital framework. The Board should also consider allowing the group to justify why it believes using the BBA approach is most appropriate for its business model, for reasons such as that the majority of regulated assets or revenue are within regulated insurance entities versus other regulated financial sectors; public perception; etc.

4. If multiple capital frameworks are used, what criteria should be used to determine whether a supervised insurance institution should be subject to each framework?

In the case of systemically important financial institutions subject to the BBA, the Board should consider additional requirements tailored to the systemically risky activities of a SIFI (an activities-based approach). The Board should recognize that additional capital is not the only solution, nor always the best solution, to dealing with all forms of risk.

5. In addition to insurance underwriting activities, what other activities, if any, should be used to determine whether a supervised insurance institution is significantly engaged in insurance activities and should be subject to regulatory capital proposals tailored to the business mix and risk profile of insurance?

The Board should defer to state insurance law and determinations of state insurance authorities, under which all of the assets of a licensed insurer support that insurer's insurance business, and are therefore insurance assets. This is another application of the basic building block concept. An insurer's investment activities support its underwriting activities. If the group also contains ancillary businesses that support its insurance business (such as an insurance agency, broker, third-party administrator, managing general agency, etc.), these businesses should also be considered as part of the insurance business.

A. Option 1: Building Block Approach

6. What are the advantages and disadvantages of applying the BBA to the businesses and risks of supervised institutions significantly engaged in insurance activities?

The advantages that the Board notes (efficient use of existing legal-entity frameworks, relatively little time required to develop and implement, lower costs for firms and capital requirements tailored to the specific risks of each jurisdiction and line of business) are all correct. The BBA is based on the successful state-based system of insurance regulation, and if properly implemented will avoid creating duplicative burdens and potential conflicts with existing regulation. It is based on the insurance business model, will be familiar to insurers and regulators, and uses U.S. based accounting principles for U.S. legal entities.

The potential weaknesses of the BBA identified by the Board are all solvable. Any regulatory arbitrage can be mitigated with the appropriate use of scalars and adjustments. Double leverage can also be eliminated through appropriate adjustments.

7. What challenges and benefits do you foresee to the development, implementation, or application of the BBA? To what extent would the BBA utilize existing records, data requirements, and systems, and to what extent would the BBA require additional records, data, or systems? How readily could the BBA's calculations be performed across a supervised institution's subsidiaries and affiliates within and outside of the United States?

We suggest that it will be easier to perform the BBA's calculations than for any other capital framework, since the BBA corresponds so closely to existing regulatory frameworks. It also seems appropriate that the BBA's calculations should generally be performed annually on a group-wide basis, although as the details of the BBA are refined this may need to be reexamined.

8. What scalars and adjustments are appropriate to implement the BBA, and make the BBA effective in helping to ensure resiliency of the firm and comparability among firms, while minimizing regulatory burden and incentives and opportunity to evade the requirements?

We suggest that scalars be used to adjust for each supervisory regime's (1) definition of qualifying capital; (2) level of conservatism in its reserves; and (3) level of required capital. The use of scalars should also be limited to significant members of the group, those whose failure could create significant financial risk to the holding company or depository institution. The ANPR is very unclear as to the Board's intentions here, and given the importance of how scalars will be applied, we ask the Board for further specificity.

We also suggest beginning with the largest non-U.S. markets in which Board-supervised insurance holding companies operate and developing scalars for those markets, with the recognition that field testing and further adjustments may be needed.

Scalars should not be used in a way that implies artificial precision. As the Board introduces the BBA, scalars should apply in broad ranges, rather than seeking narrow precision.

9. To what extent is the BBA prone to regulatory arbitrage?

Insurance groups house activities in different jurisdictions for many reasons other than capital requirements, such as the need to support the business being written in a particular jurisdiction, tax considerations, etc. For these reasons we do not believe that regulatory arbitrage within the BBA should be a significant issue. As experience is gained with the various jurisdictions and appropriate scalars are developed, regulatory arbitrage, to the extent present, should become less of an issue.

10. Which jurisdictions or capital regimes would pose the greatest challenges to inclusion in the BBA?

Jurisdictions with different accounting systems (in particular IFRS) will provide the most challenges. Again we congratulate the Board for its recognition that the capital standard applicable to U.S. insurance groups should rest on U.S. accounting systems.

The Board could consider analyzing the quality of a jurisdiction's regulatory system by historical analysis of failure rates and costs as compared to the jurisdiction's market size.

11. How should the BBA apply to a supervised institution significantly engaged in insurance activity where the ultimate parent company is an insurer that is also regulated by a state insurance regulator? Are there other organizational structures that could present challenges?

In this case the parent's qualifying and required capital under the U.S. state-based risk-based capital system should be used, except for regulated depository institutions. Assets and liabilities in depository institutions should be subtracted and then aggregated using Basel risk weights.

12. Is the BBA an appropriate framework for insurance depository institution holding companies? How effective is the BBA at achieving the goal of ensuring the safety and soundness of an insurance depository institution holding company?

Yes. We believe the BBA structure will be more effective at ensuring the safety and soundness of the holding company than any other proposed mechanism, because it is most closely aligned with the business model of the holding company's primary business. The Board's proposed Consolidated Approach implicitly assumes 100% fungibility of capital, but that assumption is in our view incorrect for it overlooks the existing structure of the insurance industry.

13. Would the BBA be appropriate for larger or more complex insurance companies that might in the future acquire a depository institution?

Yes. The Board should focus in those cases on assuring appropriate capital protection for the depository institution (an insurance holding company could provide a qualifying resolution plan, 3rd party insurance, adequate capital at the depository institution or parent support, or clearly separate name and liability to mitigate any contagion risk among the companies in that consolidated group structure).

14. In applying the BBA, what baseline capital requirement should the Board use for insurance entities, banking entities, and unregulated entities?

The RBC company action level (200% RBC level for insurance legal entities) should be the baseline requirement. This level has been the basis of successful state solvency regulation, and imposition of a higher level would be an arbitrary capital penalty imposed solely because an insurance group controls a depository institution. Other capital requirements for other members of the group should be calibrated to the 200% RBC level.

We are also concerned about the Board's default application of existing bank capital requirements to non-bank/non-insurance/non-financial unregulated subsidiaries. The risk and liquidity profiles of many insurance holding companies, especially those that are predominately non-life, vary significantly from traditional bank holding companies. Accordingly, capital standards for non-financial subsidiaries within the group will need to be appropriately tailored to the insurance model.

15. How should the BBA account for international or state regulator approved variances to accounting rules?

These practices could be reviewed on a case-by-case basis, taking account of materiality, whether the variance is more or less conservative than statutory accounting, and similar considerations. These policies should be consistent on a nationwide basis. The baseline assumption, however, should be to rely in each legal entity's case on the calculations of available capital and capital requirements of its home jurisdiction.

16. What are the challenges in using financial data under different accounting frameworks? What adjustments and/or eliminations should be made to ensure comparability when aggregating to an institution-wide level?

These challenges include the reliance on different levels of conservatism and social considerations for each regulatory regime.

The time and resources necessary to identify scalar criteria, as well as to continually review these regimes for material changes in their accounting frameworks, will also be a challenge.

17. What approaches or strategies could the Board use to calibrate the various capital regimes without needing to make adjustments to the underlying accounting?

The Board's proposed approach does not propose scaling of available capital. This makes it more difficult to reflect differences in conservatism of reserving standards, a key driver of balance sheet differences across regulatory regimes. These differences should be adjusted, using the NAIC's risk-based capital system as the basis.

18. How should the BBA address inter-company transactions?

An inventory of intragroup transactions that significantly affect required capital levels could be performed (including loans, guarantees, and investments). As part of the BBA filing, the group would disclose all adjustments made to eliminate any capital impact of these transactions.

No adjustments for affiliated reinsurance should be required for scalar compatible (equivalent) regulatory regimes. Adjustments might be necessary for affiliated reinsurance from non-scalar compatible regimes.

19. What criteria should be used to develop scalars for jurisdictions? What benefits or challenges are created through the use of scalars?

As suggested above, regulatory quality can be assessed through a historical failure analysis. The extent to which a jurisdiction includes additional conservatism in reserving standards should also be assessed.

20. What are the costs and benefits of a uniform, consolidated definition of qualifying capital in the BBA?

A uniform, consolidated definition of qualifying capital eliminates many of the benefits of the BBA. It would require adjustments to available capital without corresponding adjustments to insurance liabilities, distorting the balance between available and required capital in existing jurisdictional systems. Double leverage can be removed through adjustments, particularly with regard to intragroup transactions. The adjustments needed for a standardized capital definition would result in significant additional costs that can be avoided by a simple aggregation of local jurisdictional capital resources and capital requirements, with appropriate adjustments.

22. Should the Board categorize qualifying capital into multiple tiers, such as the approach used in the Board's Regulation Q? If so, what factors should the Board consider in determining tiers of qualifying capital for supervised institutions significantly engaged in insurance activities under the BBA?

We do not believe insurance legal entity capital should be separated into multiple tiers, and doing so will create unnecessary complexity and cost. We also believe the Board should give appropriate capital credit for both surplus notes and senior debt that has been contributed to insurance companies in the group and subject to structural subordination to policyholder claims.

We recognize it may be appropriate, if a group is in troubled financial condition, for the Board to request additional information regarding capital quality.

B. Option 2: Consolidated Approach

23. What are the advantages and disadvantages of applying the CA to the businesses and risks of supervised institutions significantly engaged in insurance activities?

We do not see any advantages to use of the CA. Its disadvantages include:

1) Construction of the CA would be a complex and massive effort, requiring the creation of an entire new balance sheet and the development of a new capital requirement covering activities across the globe for the non-bank SIFIs.
2) This task is harder for the two or three more complex institutions – it's not clear how this process can produce a better quality result than the BBA or why a longer timeframe to completion is appropriate for the largest institutions.
3) A "rough justice" approach implies either that the capital standard needs to be calibrated at a very low level (calling into question the rationale of building a new standard), or there will be material unintended strategic consequences for the two or three firms this applies to (certain products or

jurisdictions may be more or less favored by the standard vs. all other insurance groups, creating an unlevel playing field).

4) If would also be difficult for regulators to benchmark CA groups vs. BBA groups. The lack of historical experience with a CA approach would make this even more difficult to implement.

24. What are the likely challenges and benefits to the development, implementation, and application of the CA? To what extent could the CA efficiently use existing records, data requirements, and systems, and to what extent would the CA require additional records, data, or systems?

The consolidated factors applied to risks are unlikely to accurately take into account jurisdictional differences in product design and risks insured, which could result in a material mis-estimation of risk. The CA also implicitly assumes that all group capital is fungible, which in our view is not the case.

25. To what extent would the CA be prone to regulatory arbitrage?

We believe that any system based upon the CA could provide incentives to regulatory arbitrage if not constructed fairly to reflect realistic risk exposures.

26. Is the CA an appropriate framework to be applied to systemically important insurance companies? What are the key challenges to applying the CA to systemically important insurance companies? How effective would the CA be in achieving the goals of ensuring the safety and soundness of a systemically important insurance company as well as minimizing the risk of a systemically important insurance company's failure or financial distress on financial stability?

No. In order for the CA to be more meaningful than the BBA, there would need to be extraordinarily granular risk classifications with exposures and tailored risk factors for each. If the CA is only roughly separating exposures, it is not likely to be a better method of ensuring safety and solvency, and certainly not materially better to justify the additional burden the CA entails.

27. What should the Board consider in determining more stringent capital requirements to address systemic risk? Should these requirements be reflected through qualifying capital, required capital or both?

The Board should use an activities-based approach, and determine which specific activities and level of those activities create or contribute to systemic risk. It should also remember that capital is not always the optimum way to regulate all forms of risks. The Board should not impose additional and unnecessary burdens on the activities of an insurance holding company that do not present systemic risk. Instead, it should focus on the specific activities of a SIFI that could threaten the financial stability of the United States.

28. What should the Board consider in developing a definition of qualifying capital under the CA? What elements should be treated as qualifying capital under the CA?

If the Board persists in developing the CA, it should use the same elements as under the BBA, based upon statutory accounting principles (see our response to question 22).

29. For purposes of the CA, should the Board categorize qualifying capital into multiple tiers? What criteria should the Board consider in determining tiers of qualifying capital for supervised institutions significantly engaged in insurance activities under the CA?

As we stated in response to question 22, we do not believe insurance legal entity capital should be separated into multiple tiers, and doing so will create unnecessary complexity and cost. We also believe the Board should give appropriate capital credit for both surplus notes and senior debt that has been contributed to insurance companies in the group and subject to structural subordination to policyholder claims.

30. What risk segmentation should be used in the CA? What criteria should the Board consider in determining the risk segments? What criteria should the Board consider in determining how granular or risk sensitive the segmentation should be?

If the Board persists in developing the CA, risk segmentation should follow either existing GAAP classifications (fairly large buckets), or existing classifications under statutory accounting (more granular than GAAP, but similar to the BBA). Anything else adds to the operational burden and creates unnecessary conflicts with state standards. If a particular product segment is thought to be excessively (systemically) risky, the Board can work with the NAIC to modify its statement blank.

31. What challenges does U.S. GAAP present as a basis for segmentation in the CA?

Without knowing the segments the CA would prescribe, any response at this time would be premature.

C. Other Assessed Frameworks

38. Should the Board reevaluate any of these approaches? What additional consideration, if any, should the Board give to any of the regulatory capital approaches discussed above?

We do not believe the Board should reevaluate any of these approaches. The first approach would ignore the differences between the insurance and banking business models. We understand the Board's concern with ignoring insurance companies, although we disagree with application of the source of strength concept to subsidiary insurance companies. A Solvency II-type approach would be clearly inappropriate for U.S. insurers, and we do not believe stress testing is needed for insurance holding companies that are not SIFIs.

We look forward to continuing to work with the Board on this very important rulemaking. If any members of the Board or staff have any questions or comments about our submission, please contact me at 847.553.3606 or steve.broadie@pciaa.net.

Sincerely,

Stephen W. Broadie
Vice President, Financial Policy